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# DIVORCE, TAXES, AND THE 1984 TAX REFORM ACT: AN INADEQUATE RESPONSE TO AN OLD PROBLEM

Roland L. Hjorth\*

The proper income tax treatment of property transfers and cash payments made because of divorce has never been satisfactorily resolved in the United States.<sup>1</sup> In 1942 Congress provided that certain periodic support payments made pursuant to separation or divorce would be income to the payee and deductible by the payor.<sup>2</sup> The statutory provisions applied only to payments made for support.<sup>3</sup> The provisions did not apply to payments made to compensate a spouse for a vested property interest<sup>4</sup> or for an inchoate right, such as dower, even if the payments were called maintenance and met the formal requirements of sections 71 and 215 of the Internal Revenue Code, relating to alimony.<sup>5</sup> Support payments specifically designated as child support were not deductible by the payor and were not income to the payee, but payments were not presumed to be child support unless specifically so designated.<sup>6</sup> Thus, by 1984, property settlement payments could not be converted into alimony, but child support payments could.

The income tax treatment of property settlement cash payments, and of property transfers made pursuant to divorce, had become quite complex by 1984. Cash payments made for "inchoate rights" were not income to the

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1. In 1917 the Supreme Court ruled that alimony was not income to the recipient and was not deductible by the payor. *Gould v. Gould*, 245 U.S. 151 (1917).

2. The original alimony provisions were added by § 120 of the Revenue Act of 1942, ch. 619, 56 Stat. 798, 816-17 (codified as §§ 22(k) and 23(u) of the Internal Revenue Code of 1939). The statute was prompted, in part, by high wartime tax rates, which "intensified] the hardship of payment of alimony out of after-tax income." STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 713-14 (Comm. Print 1984) [hereinafter cited as GENERAL EXPLANATION]. The deduction for alimony was originally an itemized personal deduction that could not be taken unless the taxpayer itemized deductions. In 1976 alimony became deductible in arriving at adjusted gross income "so that a taxpayer who does not itemize deductions may nevertheless deduct alimony." *Id.* at 714. Alimony continues to be deductible in arriving at adjusted gross income. I.R.C. § 62(13) (CCH 1985).

3. *Phinney v. Mauk*, 411 F.2d 1196, 1198 (5th Cir. 1969).

4. *Treas. Reg.* § 1.71-1(c)(4) (1985); *Boucher v. Commissioner*, 710 F.2d 507, 509-10 (9th Cir. 1983); *Widmer v. Commissioner*, 75 T.C. 405, 408 (1980); *Newbury v. Commissioner*, 46 T.C. 690, 697 (1966).

5. *Bernatschke v. United States*, 364 F.2d 400, 404 (Ct. Cl. 1966); *McCombs v. Commissioner*, 397 F.2d 4, 7-8 (10th Cir. 1968).

6. *Commissioner v. Lester*, 366 U.S. 299, 301 (1961).

payee and were not deductible by the payor.<sup>7</sup> In addition, the imputed interest rules did not apply to such payments.<sup>8</sup> Cash payments made for vested property interests were taxable sales that could cause the selling spouse to recognize taxable gain, and part of such payments might constitute imputed interest under section 483.<sup>9</sup> If property was not sold, but was simply transferred from one spouse to another pursuant to divorce, the spouse who made the transfer was deemed in *United States v. Davis* to have received consideration equal to the fair market value of the property transferred.<sup>10</sup> The "consideration" was presumed to be a complete or partial discharge of obligations arising out of the marital relationship. Approximately equal divisions of community property or other co-owned property, however, were not taxed.<sup>11</sup> Although equal divisions of co-owned property often involved exchanges of property, in the sense that each spouse transferred an undivided half interest in all assets in return for the entire interest in part of the assets, a nonstatutory nonrecognition rule governed. That nonrecognition rule did not, however, extend to situations where an interest in co-owned property was sold by one spouse to the other as, for example, where a wife sold her interest in community property for her departing husband's promissory notes.<sup>12</sup>

This conglomeration of rules pleased almost no one. The rule that a spouse could recognize gain from the transfer of appreciated property to another spouse pursuant to divorce was especially unpopular.<sup>13</sup>

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7. *Sydnies v. Commissioner*, 68 T.C. 170, *aff'd*, 577 F.2d 60 (8th Cir. 1978); *Hall v. Commissioner*, 44 T.C.M. (CCH) 1418 (1982).

8. *Fox v. United States*, 510 F.2d 1330 (3d Cir. 1975); Rev. Rul. 76-146, 1976-1 C.B. 144. Payments for property interests that vested only upon commencement of a divorce action have been held to be immune from the imputed interest rules of I.R.C. § 483 (CCH 1985). *Gammill v. Commissioner*, 710 F.2d 602 (10th Cir. 1982).

9. *Gerlach v. United States*, 201 Ct. Cl. (CCH) 884, ¶ 9425 (1973).

10. 370 U.S. 65 (1962). The spouse who received the property had no income. Rev. Rul. 67-221, 1967-2 C.B. 63. The basis of the transferee spouse was stepped up to its fair market value on the date of transfer. *Farid-es-Sultaneh v. Commissioner*, 160 F.2d 812, 813 (2d Cir. 1947).

11. *Schacht v. Commissioner*, 47 T.C. 552 (1967), *acq.*, 1968-2 C.B. 2; *Harrah v. Commissioner*, 70 T.C. 735 (1978). In 1981 the Internal Revenue Service announced that the nontaxable equal division rule applicable to community property also applied to property held in some form of concurrent ownership in community property jurisdictions. Rev. Rul. 81-292, 1981-2 C.B. 158.

12. *Carrieres v. Commissioner*, 64 T.C. 959, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977). The rule was also inapplicable to unequal divisions of co-owned property. The spouse who received the smaller portion of property was deemed to transfer some of his or her share of the property to the other spouse in discharge of a marital obligation. Rev. Rul. 74-347, 1974-2 C.B. 26. See *Siewert v. Commissioner*, 72 T.C. 326 (1979).

13. The American Bar Association Section on Taxation recommended, as early as 1966, that the result in *United States v. Davis*, 370 U.S. 65 (1962), be overruled by legislation. *Report of the Committee on Domestic Relations Tax Problems*, 19 A.B.A. SEC. TAX'N BULL. 62, 63-66 (1966). The transferee of the property would inherit the transferor's basis and holding period. The unpopularity of the *Davis* rule is illustrated by the fact that very few property transfers pursuant to divorce (other than sales for cash) have been held to be taxable. Courts began diminishing the significance of the *Davis* case

A second and less obvious problem was presented by the alimony rules. Cash payments were within the alimony framework only if they were for "support." The test of whether payments were for support was difficult to apply and could put the government into a whipsaw position: payors might deduct payments alleged to be support payments even if the payments were excluded by payees who asserted that such payments were for a property interest or for an inchoate right that was eliminated by a divorce. The government could effectively protect revenues only by auditing and asserting deficiencies against both spouses, and much revenue was undoubtedly lost.<sup>14</sup>

These concerns led to the adoption in 1984 of the Domestic Relations Tax Reform Act (DRTRA), as part of the Tax Reform Act of 1984.<sup>15</sup> That Act adds a new code section 1041, which provides that no transfer of property between spouses during marriage or pursuant to divorce can be taxable, and completely revises the alimony rules in sections 71 and 215.

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by finding transfers to be nontaxable divisions of co-owned property. The high water mark in this area is *Imel v. United States*, 375 F. Supp. 1102 (D. Colo. 1973), *aff'd*, 523 F.2d 853 (10th Cir. 1975). The *Imel* court found that the wife's interest in marital property became a "species of common ownership" under Colorado law when the divorce action was filed (even though the property was the separate property of the husband before that time), so that a subsequent transfer of some of that property to her pursuant to divorce was a nontaxable division of co-owned property. *Id.* at 1112-13. The extreme reluctance of courts to find taxable transfers made pursuant to divorce is also illustrated by the case of *Cook v. Commissioner*, 80 T.C. 512 (1983), in which a husband transferred to a wife, pursuant to divorce, property which she had earlier given to him. The Tax Court found that the transfer was not taxable because the wife had always had a "quasi-ownership" interest in the property. *See also McIntosh v. Commissioner*, 85 T.C. 31 (1985).

14. *See, e.g., Beard v. Commissioner*, 77 T.C. 1275 (1981), in which a wife to whom a former husband made periodic payments did not report those payments as income even though the former husband deducted them. The Tax Court held that the payments were nondeductible property settlement payments based upon "surrounding facts and circumstances." A "surrounding facts and circumstances" test is clearly unsatisfactory because a payee is likely to interpret those facts to mean property settlement and the payor is likely to interpret the same facts to mean "support." This issue was presented with disturbing frequency under prior law. *See, e.g., Hall v. United States*, 749 F.2d 373 (7th Cir. 1984); *Schatten v. United States*, 746 F.2d 319 (6th Cir. 1984); *Slawski v. United States*, 6 Cl. Ct. (CCH) 433 ¶ 9868 (1984), *aff'd mem.*, 770 F.2d 180 (Fed. Cir. 1985). Any responsible proposal for revision of tax laws relating to divorce must address this problem, which seems to be a far more significant problem than the *Davis* problem. *See supra* notes 10-13 and accompanying text.

15. The Domestic Relations Tax Reform Act (DRTRA) was the culmination of five years of effort involving the American Bar Association, private sector experts, and the government. The effort is chronicled in detail in O'Connell, *The Domestic Relations Tax Reform Act: How We Got It and What We Can Do About It*, 18 FAM. L. Q. 473 (1985). DRTRA is contained in §§ 421-26 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 792, under the heading of "tax simplification." The Act was signed by the President on July 18, 1984. The House Bill contained domestic relations tax provisions, but the Senate Bill did not. The final provisions were adopted by the Conference Committee. The amendments contained in the Conference Report (and thus in the Act) were therefore never considered by any full committee. DRTRA is explained in pages 1116-20 of H.R. REP. NO. 861, 98th Cong., 2d Sess. (1984), *reprinted in* 1984-3 C.B. 370-74. The explanation is amplified in GENERAL EXPLANATION, *supra* note 2, at 710-25. Temporary Regulations in the form of questions and answers [hereinafter Q & A] have been promulgated. Treas. Reg. §§ 1.71-1T, 1.1041-1T (1984).

The purpose of the alimony revisions was to retain the basic standard that payments should be alimony only if made for support, but to replace the general and undefined support requirement with a series of objective tests that would be easy to meet if the payments were support payments in fact, but that would be difficult to meet in typical property settlement situations.<sup>16</sup>

More specifically, section 1041 provides that no gain or loss shall be recognized on any transfer between spouses during marriage or pursuant to divorce, even if the transfer is a cash sale.<sup>17</sup> Because section 1041 denies the existence of taxable sales between spouses pursuant to divorce, original issue discount and imputed interest rules apparently will not apply to installment sales made between spouses pursuant to divorce.<sup>18</sup> The principal changes in the alimony rules are as follows: (1) the requirement that payments be for support in order to be alimony is eliminated; (2) payments are not deductible unless they terminate on the death of the payee spouse and the divorce or separation instrument expressly so provides;<sup>19</sup> (3) payments in excess of \$10,000 per year are deductible only if some payments must be made in at least six postseparation years;<sup>20</sup> (4) if payments are to be made in each year within the six-year postseparation period, a reduction in payments of more than \$10,000, comparing any later year in the period with any earlier year, will cause the payor of alimony to have hypothetical income in the year in which the reduction occurs.<sup>21</sup>

These changes, presumably designed to allow deduction of support payments and frustrate attempts to deduct the cost of purchasing property pursuant to divorce, accomplish neither result. A person who is ordered to

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16. "The committee bill attempts to define alimony in a way that would conform to general notions of what type[s] of payments constitute alimony as distinguished from property settlements and to prevent the deduction of large, one-time lump sum property settlements." REPORT OF HOUSE WAYS AND MEANS COMMITTEE ON H.R. 4170, H.R. REP. NO. 432, 98th Cong., 2d Sess. 1495 (1984).

17. In addition to property transfers made during marriage, I.R.C. § 1041 applies to all property transfers made after July 18, 1984, pursuant to divorce or separation instruments executed or issued after that date. If both spouses agree, § 1041 can also apply to all transfers made after 1983 or to all transfers made after July 18, 1984, pursuant to instruments issued or executed before that date. Tax Reform Act of 1984, Pub. L. No. 98-369, § 421(d), 98 Stat. 494, 795.

18. See *infra* notes 54-64 and accompanying text.

19. I.R.C. § 71(b) (CCH 1985). The new alimony rules apply to divorce and separation instruments executed after December 31, 1984. Tax Reform Act of 1984, Pub. L. No. 98-369, § 422(e), 98 Stat. 494, 795. They can also apply to pre-1985 instruments that are modified after 1984 if the modification states that the new rules shall apply. To modify any pre-1985 agreement or decree to qualify payments as alimony appears possible where, for example, payments were not deductible under prior law because they were not for support. It is not clear, however, whether a spouse who claims a cost basis in assets purchased from the other spouse pursuant to divorce prior to 1985 can modify the decree so as to make the installment payments deductible.

20. I.R.C. § 71(f)(1) (CCH 1985).

21. I.R.C. § 71(f)(2) (CCH 1985). The payee will have an offsetting deduction.

pay a former spouse \$18,000 per year for four years while that spouse prepares to reenter the job market will not be able to deduct those payments that exceed \$10,000 per year, even if they are purely for the spouse's support. On the other hand, a person who purchases a former spouse's interest in community property for \$50,000 per year for seven years may be able to deduct all payments.

The final major change effected in 1984 relates to child support payments. Payments specifically designated as child support were never income to the payee or deductible by the payor, but payments were not treated as child support payments unless they were specifically so designated.<sup>22</sup> Undifferentiated maintenance was all deductible so long as none of it was expressly designated child support.<sup>23</sup> This rule, known as the "*Lester* Rule,"<sup>24</sup> was repealed in 1984. Under DRTRA, child support payments cannot be deducted, even if they are not specifically designated as child support. Moreover, payments that terminate or decrease upon the occurrence of a contingency relating to a child (or that can be clearly associated with such an occurrence) now constitute nondeductible child support.<sup>25</sup> We have thus come full circle: child support payments cannot be converted into deductible alimony, but property settlement payments can.

This article analyzes in detail the provisions of the 1984 Tax Reform Act relating to property settlements and cash payments made pursuant to divorce. It concludes that the provisions relating to property settlements are, on balance, beneficial, but that the changes relating to alimony and child support are almost totally devoid of merit. The article recommends that sections 71 and 215 be amended to provide that all cash payments made pursuant to divorce should be income to the recipient if those payments meet the formal requirements of new section 71(b). Even if the payments are income to the recipient, however, the payor should not be able to deduct payments unless the payor can show that they are in the nature of support payments, as under prior law. Special rules relating to "excess front-loading of alimony payments" (the six-year rule and the alimony recapture rule) should be repealed. Because no cogent reasons have been advanced for repealing the *Lester* Rule, this article recommends that the *Lester* Rule be reinstated by a provision permitting child support payments to be

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22. Internal Revenue Code of 1954, ch. 736, § 71(b), 68A Stat. 19.

23. "If . . . the periodic payments are received by the wife for the support and maintenance of herself and of minor children of the husband without . . . specific designation of the portion for the support of such children, then the whole of such amounts is includible in income of the wife . . . ." Treas. Reg. § 1.71-1(e) (1957).

24. *Commissioner v. Lester*, 366 U.S. 299 (1961). The *Lester* case holds that maintenance is "undifferentiated" even if a portion thereof will terminate upon the occurrence of a contingency relating to a child.

25. I.R.C. § 71(c)(2) (CCH 1985).

deducted by the payor if the parties agree that the payee will report the payments as income.

## I. PROPERTY SETTLEMENTS

### A. *Nonrecognition of Gain on Property Settlement Transfers*

New section 1041 provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse or, if the transfer is incident to divorce, to a former spouse. The same rule applies to a transfer in trust for the benefit of a spouse or a surviving spouse. For income tax purposes, the transfer is treated somewhat (but not exactly) like a gift, and the basis of the transferee is the adjusted basis of the transferor. A property transfer is "incident to divorce" if it occurs within one year after the date on which the marriage ceases, or is "related to the cessation of the marriage." A special rule states that the rule of nonrecognition does not apply to transfers made during marriage when the transferee spouse is a nonresident alien. If the transfer is to a former spouse incident to divorce the rule of nonrecognition applies even if the transferee is a nonresident alien.<sup>26</sup>

#### 1. *Transfer "From an Individual to a Spouse"*

Section 1041 does not apply to a transfer from an individual to a person who is not that individual's spouse or from an individual to a corporation. Thus, repurchase of the shares of one spouse by a corporation controlled by the other spouse is a taxable event to the spouse whose shares are redeemed. The repurchase can also be taxable to the corporation if the corporation uses appreciated property to redeem the shares.<sup>27</sup>

For example, assume that a husband owns 100 shares of stock in a corporation whose other 100 shares are owned by his wife. If the wife acquires the husband's shares pursuant to divorce by means of a direct purchase, the husband recognizes no gain. If, instead, the corporation repurchases the husband's shares, the sale is a taxable event even though the wife ends up owning 100% of the corporation.

If the corporation is an "S corporation,"<sup>28</sup> and the sale of shares to the corporation is an installment sale with stated interest, the deduction for interest is in effect passed through to the spouse who continues as a

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26. Literally, a transfer to a transferee who is a nonresident alien is taxable, even if the transfer is pursuant to divorce, if the transfer occurs before the divorce, but not if it occurs after. If a nontaxable transaction is desired, care should be taken that a transfer to a nonresident alien spouse does not occur until after the divorce. I.R.C. § 1041(d) (CCH 1985).

27. I.R.C. § 311 (CCH 1985).

28. In general, the income of "S corporations" is taxed directly to their shareholders. Deductions of "S corporations" are passed through to shareholders. I.R.C. §§ 1363, 1366 (CCH 1985).

shareholder. Controlled corporations can be used in other ways to achieve taxable sale treatment. If one spouse owns an interest in appreciated property that the other spouse wishes to acquire in a taxable transaction, the selling spouse could sell the property to an S corporation owned by the other spouse. The selling spouse would report gain or loss, the S corporation would obtain a cost basis in the purchased property,<sup>29</sup> and, if the purchase qualifies as an installment purchase with stated interest, the shareholder spouse can obtain the benefit of interest deductions.<sup>30</sup>

## 2. *Transfer "During Marriage"*

A transfer made before marriage in consideration of marriage would appear to be a taxable event,<sup>31</sup> but a transfer made during marriage pursuant to an agreement before marriage would not. While this distinction may appear to depend on form rather than substance, it is a practical distinction that eliminates the question of whether cash sales between persons who later marry are taxable events.

A transfer "during marriage" presupposes a marriage, but a transfer is "incident to divorce" even if made pursuant to an annulment decree declaring that a valid marriage never existed.<sup>32</sup> It seems reasonable to expect that parties will be considered married for purposes of section 1041 only if they go through a marriage ceremony that they believed to be valid at the time of the ceremony. Section 1041 should not be extended to relationships that do not appear to be valid marriages on their face. The Tax Court should not be called upon to decide what kinds of living arrangements short of marriage are nevertheless marriages for tax purposes. Thus, all cash sales between unmarried persons should be taxable even if the persons live together, unless the parties went through a marriage ceremony they reasonably believed to be valid at the time it was celebrated. Presumably, the principle of the *Davis* case will continue to apply to those cases where one person transfers appreciated property to another in discharge of an obligation arising out of a personal relationship.<sup>33</sup>

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29. See Treas. Reg. § 1.1041-1T(a)(example (3)) (1984).

30. The "S corporation" would obtain interest deductions under I.R.C. § 163 even if the installment sales contract did not provide interest. See I.R.C. §§ 483, 1272-75 (CCH 1985).

31. See *Farid-es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947).

32. Treas. Reg. § 1.1041-1T(b)(Q & A 8) (1984). The Regulations state that "annulments and cessations of marriages that are void *ab initio* due to violations of state law constitute divorces for purposes of § 1041 . . . ." It is reasonable to conclude that an annulment of a marriage that the parties believe to be genuine constitutes a divorce even if the "marriage" did not violate state law.

33. *United States v. Davis*, 370 U.S. 65 (1962). The broad principle underlying the *Davis* case has not been repealed. A person who satisfies a legal obligation by transferring appreciated property to the obligee realizes gain. As a practical matter, transfers of property pursuant to the termination of a



### 3. *Transfer "Incident to Divorce"*

A transfer is incident to divorce if it occurs within one year after the parties cease to be married or is related to the divorce.<sup>34</sup> A transfer is related to the divorce if it is made pursuant to a divorce or separation instrument and occurs not more than six years after the date on which the marriage ceases. A transfer occurring more than six years after cessation of the marriage is presumed not to be related to the divorce. The presumption can be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage.<sup>35</sup>

The statute does not say when a marriage "ceases," but it would be appropriate to rule that it ceases only upon issuance of a divorce or separation decree. The statute also fails to list the circumstances under which a postdivorce sale is (or is not) "incident to" a divorce or separation instrument. Clearly a transfer from one spouse to the other spouse ordered by a divorce or separation instrument is incident to that instrument. On the other hand, a postdivorce transfer of property made in satisfaction of an unpaid alimony obligation, although it can be traced to a divorce or separation instrument, should not be held to have been made incident to that instrument.<sup>36</sup>

Some of these ambiguities may be illustrated by the common situation in which possession of a family residence is awarded to one spouse for a limited period of time, with the requirement that at the end of the period the property be sold and the proceeds divided. In this case no transfer occurs until the later sale because both spouses share in the eventual appreciation (or depreciation) in value of the residence. If the residence is sold to a third party at the end of the time period, section 1041 would not apply because there is no transfer of property from one spouse to another. If, instead, the possessory spouse buys the interest of the nonpossessory spouse, the transfer would be a taxable sale if the transfer occurred more than one year after the date the marriage ceased. On the other hand, if the sale occurred within one year from the date the marriage ceased, the sale would be a

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relationship never held out as a marriage will probably qualify as divisions of co-owned property or as gifts. *See supra* note 13.

34. I.R.C. § 1041(c) (CCH 1985).

35. Treas. Reg. § 1.1041-1T(b)(Q & A 7) (1984).

36. But the proper resolution of this issue is by no means clear. Assume, for example, that property is awarded to one spouse who is ordered to make payments to the other spouse that qualify as alimony under I.R.C. § 71. The payee may obtain a security interest in the property of the payor in order to secure payment. If the payee forecloses on the security interest in order to satisfy the payor's alimony obligation, the payor would obtain no deduction because "alimony" for tax purposes is limited to cash payments. If the payor recognizes gain on the transfer, he or she would have income with no offsetting deduction.

nontaxable transfer. In addition, if the divorce or separation instrument requires the possessory spouse to purchase the interest of the non-possessory spouse at the end of a stated period of time at its fair market value at that time, the transfer would be incident to divorce, even if it occurs more than six years after the date the marriage ceases.

The circumstance just described should be distinguished from another common case in which the spouse to whom possession is awarded is ordered to pay the nonpossessory spouse a fixed sum at a later date. Because the amount to be paid is fixed, the nonpossessory spouse has no further interest in the appreciation or depreciation of the residence. The sale occurs at the time the divorce or separation instrument is issued.<sup>37</sup> The nonpossessory spouse would have no income upon later collection of proceeds from the possessory spouse. All gain on eventual sale to a third party would be taxed to the possessory spouse.<sup>38</sup> On balance, these results would be favorable to both spouses because only the possessory spouse can take advantage of tax benefits available to persons who sell their principal residences.<sup>39</sup>

#### 4. *Treatment as Gift for Income Tax Purposes*

A donor normally recognizes no gain upon transferring property by gift. A donee usually assumes the donor's holding period in the property and takes the property subject to the tax attributes the property had in the hands of the donor.<sup>40</sup> In the case of true gifts, there are exceptions to these rules: a donor can recognize gain if consideration received exceeds the donor's

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37. Such a transfer is an installment sale occurring at the time the divorce or separation instrument is issued, with at least one payment to be made in a year later than the year of sale. I.R.C. § 453 (CCH 1985). The issue of whether imputed interest would apply to such a transfer is discussed *infra* notes 54-61 and accompanying text.

38. That is, the possessory spouse is treated as if the property were received in a gift transfer. The basis would be unchanged and all gain would be recognized on ultimate sale.

39. See I.R.C. §§ 121, 1034 (CCH 1985). Section 121 enables certain taxpayers 55 years or older to disregard up to \$125,000 in computing gain on the sale of a principal residence. Section 1034 enables taxpayers to postpone recognition of gain from the sale of a principal residence to the extent proceeds are reinvested in a new residence within two years. The two provisions may be combined. For example, if a taxpayer over 55 sells a principal residence in which his or her basis was \$100,000, for \$400,000, up to \$125,000 may escape tax forever. Other tax may be postponed if the remaining \$275,000 is invested in a new residence. If a new residence is purchased for less than \$275,000, gain is recognized only to the extent that \$275,000 exceeds the cost of a new residence. Section 121 is available only to a taxpayer who occupied the residence as his or her principal residence for three of the five years preceding the date of sale. Section 1034 is available only if a new residence is purchased within two years from the date of sale of an old principal residence. A possessory spouse 55 years or older could usually meet all these requirements. A nonpossessory spouse would have difficulty meeting the requirements if the sale of the residence occurs more than two years after the nonpossessory spouse moves out.

40. I.R.C. § 1015 (CCH 1985).

basis, as when property is transferred subject to debt;<sup>41</sup> a donor can recognize gain upon the transfer of installment obligations;<sup>42</sup> and the basis of a donee in property, for purposes of determining subsequent loss, is the lower of the donor's basis or fair market value at the time the gift is made.<sup>43</sup>

None of these exceptions apply to transfers during marriage or pursuant to divorce. A spouse who transfers property subject to a debt in excess of basis (or for full cash consideration) recognizes no gain or loss,<sup>44</sup> a transfer of installment obligations is not taxable,<sup>45</sup> the transferee always takes the basis of the transferor,<sup>46</sup> and a transfer during marriage or pursuant to divorce cannot generate depreciation recapture or investment tax credit recapture.<sup>47</sup> One should remember that under the new regime all tax burdens that attach to property pass to the transferee. For example, if a husband, pursuant to divorce, transfers to his wife property subject to investment tax credit recapture on sale or on conversion to personal use, the husband's transfer does not generate investment tax credit recapture to him, but the wife's conversion of the property to personal use generates investment tax credit recapture to her.<sup>48</sup>

## 5. *Transfer to Nonresident Aliens*

Transfers to and from nonresident aliens incident to divorce do not generate gain or loss. But transfers during marriage to a nonresident alien spouse are taxable.<sup>49</sup> If such transfers were not taxed, tax on appreciated property could be avoided entirely because the nonresident alien is presumably not subject to United States tax<sup>50</sup> and could resell the property without

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41. See *Lefkowitz v. Commissioner*, 40 T.C.M. (CCH) 978 (1980). The donee's basis in such a case is the amount paid by the donee if the amount paid exceeds the donor's basis.

42. I.R.C. § 453B (CCH 1985).

43. I.R.C. § 1015(a) (CCH 1985). Also, a donee's basis is increased for gift tax paid and attributable to appreciation in value of the property. I.R.C. § 1015(d) (CCH 1985). Gift tax would normally not be paid on transfers made pursuant to divorce even though such transfers are treated as "gifts" for income tax purposes. I.R.C. § 2516 (CCH 1985).

44. Treas. Reg. § 1.1041-1T(d)(Q & A 12) (1984).

45. I.R.C. § 453B(g) (CCH 1985).

46. I.R.C. §§ 1041(b)(2), 453B(g)(2) (CCH 1985).

47. I.R.C. §§ 1245(b)(1), 1250(d)(1) (CCH 1985) (depreciation recapture); I.R.C. § 47(e)(2) (CCH 1985) (investment tax credit recapture).

48. Treas. Reg. § 1.1041-T(d)(Q & A 13) (1984). See also I.R.C. § 280F(b) (CCH 1985) (providing for depreciation recapture in some cases where certain "listed property" (e.g., autos and personal computers) is converted from predominantly business use to predominantly personal use).

49. I.R.C. § 1041(d) (CCH 1985).

50. If the nonresident alien resells the property outside the United States the gain would not be subject to United States tax. I.R.C. § 871 (CCH 1985). Even if the nonresident alien resells the property within the United States, that person's capital gains from United States sources would not usually be taxed unless the property is real estate. I.R.C. §§ 871(b), 897 (CCH 1985).

either spouse being required to pay United States tax. Transfers during marriage from a nonresident alien spouse to a resident or citizen are within the nonrecognition rules of section 1041. Thus, if a nonresident alien spouse sells (or gives) appreciated property to a resident spouse, the resident spouse does not get a cost basis in the property.

### 6. *Conforming Changes*

Prior to adoption of DRTRA, other provisions of the Code applied in a special way to taxable transfers between spouses. Notable among these were provisions relating to the sale of appreciated depreciable property. Gain recognized on such sales was taxable as ordinary income if the sales were between spouses during marriage.<sup>51</sup> Moreover, gain was recognized immediately on such sales if the depreciable property was sold for deferred payments.<sup>52</sup> Because no gain can now be recognized, these provisions are unnecessary and have been repealed.<sup>53</sup>

### B. *The Problem of Interest on Installment Sales*

#### 1. *No Interest Stated*

If property is sold by one spouse to another pursuant to divorce in return for deferred payments, it is not clear whether any of the imputed interest

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51. Internal Revenue Code of 1954, ch. 736, § 1239(a)(1), 68A Stat. 1, 332 (ordinary income on sale of appreciated depreciable property between spouses), was repealed by § 421(b)(6)(A) of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 794.

52. Installment Sales Revision Act of 1980, Pub. L. No. 96-471, § 2(a), 94 Stat. 2247, 2251 (codified as § 453(h)(1) of the Internal Revenue Code of 1954) (requiring immediate recognition of gain on installment sales between husband and wife) was amended by § 421(b)(6)(B) of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 794.

53. See *supra* notes 51–52. Section 421(b) of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 794, repealed sections 72(k) and 101(e) of the Internal Revenue Code of 1954, ch. 736, 68A Stat. 1, 24, 28. Former I.R.C. § 72(k) provided that the annuity rules did not apply to annuity payments includible in the income of the “wife under section 71 or section 682.” Under prior law a wife could be taxed on the entire amount of annuity payments if her husband purchased that annuity for her pursuant to divorce. The “investment in the contract” could not be excluded. Treas. Reg. § 1.72-14(b) (1956). Under the new law, if one spouse purchases an annuity for the other (beneficiary) spouse, the beneficiary will be treated as the purchaser of the contract and will be able to exclude the “investment in the contract” in accordance with the rules of I.R.C. § 72.

Former I.R.C. § 101(e) provided that the exclusion from gross income did not apply to payments includible in the gross income of the beneficiary under I.R.C. § 71 or § 682. Presumably this means that if a spouse, obligated to pay alimony for periods after his or her death, satisfied that obligation by purchasing life insurance in favor of the recipient of alimony, periodic payments from the policy would be taxed to the beneficiary. With the repeal of I.R.C. § 101(e), a surviving ex-spouse who receives payments under an insurance contract, in satisfaction of alimony claims, will be taxed like any other insurance beneficiary.

rules, original issue discount rules, or below-market loan rules apply.<sup>54</sup> It is not even certain that amounts stated to be interest in such contracts would be treated as interest for tax purposes.

Assume, for example, that a husband and wife jointly own property worth one million dollars. Pursuant to divorce, all property is awarded to the husband, who is ordered to pay his wife \$50,000 per year for fifteen years.

If this were a sale between unrelated parties, the obligation of the purchaser would be discounted to a present value based on assumed interest rates. The excess of the face value of the obligations over their present discounted value would be taxed to the seller as interest and would be deductible by the buyer. In some transactions the interest would be taxed to the seller as the interest accrues (whether or not paid),<sup>55</sup> and in other cases the interest would be taxed to the seller only as payments are received.<sup>56</sup>

The rules just described apply only to deferred payments made in respect of transactions that are "sales" for income tax purposes. A transfer of property between spouses pursuant to divorce is not a "sale." This is more

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54. These rules are contained in I.R.C. §§ 483 (imputed interest), 1272-74 (original issue discount), and 7872 (below-market loans). Section 1274 applies to "any debt instrument given in consideration for the sale or exchange of property," except as otherwise provided. Section 1274(c) exempts from the application of § 1274: (1) sales of farms for less than \$1,000,000; (2) sales of principal residences; and (3) sales involving total payments of \$250,000 or less. Section 483 applies, generally, to sales to which § 1274 does not apply. Both §§ 483 and 1274 determine whether a debt instrument carries "unstated interest" by discounting the payments to be made (principal and interest) to present value using an interest rate equal to 110% of the applicable federal rate.

Thus, if the debt instruments call for payment of interest equal to or in excess of the applicable federal rate, there is no "unstated interest." But if there is unstated interest after applying the preceding test, the value of all payments is discounted to present value using an interest rate of 120% of the applicable federal rate. The excess of the stated payments over present discounted value is unstated interest. For example, if X agrees to pay Y \$10,000 in five years time with no interest stated, the present value of the obligation at the appropriate interest rate might be \$6000. The excess of \$10,000 over \$6000, or \$4000, would be "original issue discount" if § 1274 applies or "imputed interest" if § 483 applies. The practical difference is that if § 1274 applies, the obligee must accrue interest and report income each year. If § 483 applies, the interest income need not be reported until payments are received. Applicable federal rates are determined monthly. Treas. Reg. § 1.1274-6T (1985). See, e.g., Rev. Rul. 85-137, 1985-35 I.R.B. 6.

Section 7872, relating to interest-free loans or below-market loans, does not apply to transactions to which "section 483 or 1274 applies." I.R.C. § 7872(f)(8) (CCH 1985). It applies to gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans and other below-market loans specified in the regulations "if the interest arrangements of the loan have a significant effect on any Federal tax liability of the lender or the borrower." Section 7872 operates in a manner similar to the original issue discount rules with one important difference: the imputed interest rate is the "applicable federal rate," not 120% of that rate.

55. I.R.C. §§ 1272-74 (CCH 1985).

56. I.R.C. § 483 (CCH 1985).

than a matter of semantics. It has been successfully argued that post-separation periodic payments have no tax consequences unless they constitute maintenance or alimony payments. In *Fox v. United States*,<sup>57</sup> the Third Circuit held that payments from one spouse to another that do not constitute "alimony" cannot generate an imputed interest deduction to the payor or income to the payee. The court noted that the starting point in determining deductions for periodic payments made pursuant to divorce is section 215, relating to alimony, and that "here, the start is also the finish."<sup>58</sup> In other words, the alimony rules preempt the field. In the *Fox* case the payee spouse received payments for "inchoate" rights rather than for vested property rights.

Earlier, in *Gerlach v. Commissioner*,<sup>59</sup> a payor was allowed a deduction for imputed interest on payments originally claimed to be deductible alimony, but found to be payments for a property interest sold to the payor by the payee. The court in *Gerlach* found that the transaction was a taxable sale of property. The payee had reported the transaction as an installment sale with imputed interest, but the taxpayer (the payor) had deducted all payments as alimony payments. The Government asserted that the payments were not alimony because they were property settlement payments. The Government conceded that, if the payments were not alimony, the taxpayer was entitled to a deduction for imputed interest. The court held that the payments were not alimony and allowed the taxpayer a deduction for imputed interest. *Gerlach* can perhaps be distinguished from *Fox* in that *Gerlach* involved an installment sale of a vested property interest, while *Fox* involved installment payments for "inchoate rights." Too much should not be made of this distinction, however, because the imputed interest issue was not contested by the parties or seriously considered by the court in *Gerlach*.

A more recent case, *Gammill v. Commissioner*,<sup>60</sup> involved a situation in which all the property of the husband and wife was acquired during marriage. The property was not community property, but under Oklahoma law the wife had a "vested interest" in the property. A disproportionately large portion of the property was awarded to the husband, who agreed to pay the wife \$250,000 over a twenty-year period. The wife retained a security interest in some of the property settlement payments, which were not income to the wife and not deductible by the husband. The court held

57. 510 F.2d 1330 (3d Cir. 1975). The Internal Revenue Service takes the same position. Rev. Rul. 76-146, 1976-1 C.B. 144.

58. *Fox*, 510 F.2d at 1334.

59. *Gerlach v. Commissioner*, 201 Ct. Cl. 884, 74-1 U.S.T.C. (CCH) ¶ 9425 (1973).

60. *Gammill v. Commissioner*, 73 T.C. 921 (1980), *aff'd*, 710 F.2d 607 (10th Cir. 1982).

that the imputed interest rules of section 483 did not apply. The Tax Court noted the *Gerlach* case, but distinguished the case on the ground that the court "did not consider the [imputed interest] issue."

The 1984 Act treats property transfers and cash payments as unrelated transactions. If property is transferred for installment notes pursuant to divorce, the property transfer is a gift transfer whose consequences are governed by section 1041. Payments on the installment notes are deductible by the payor if the requirements of sections 71 and 215, relating to alimony, are met. If those requirements are not met, each subsequent payment should be treated as if it were a payment totally unrelated to a property transfer. So treated, the *Fox* case should apply. Here, also, the start should be the finish.

Similarly, the interest-free loan rules of section 7872, which impute market rate interest in transactions calling for inadequate interest, would appear to be preempted by sections 71 and 215 in sales made pursuant to divorce. The rules of section 7872 apply to gift loans, compensation-related loans, corporation-shareholder loans, tax avoidance loans, and other loans "to the extent provided in regulations." Installment notes issued in sales pursuant to divorce are not gift loans, because the foregoing of interest is not in the nature of a true gift.<sup>61</sup> Also, such loans are clearly not "compensation-related" or "corporation-shareholder" loans and would not necessarily be tax-motivated. The Secretary could presumably bring such loans within the scope of section 7872, but to do so would raise anew the question of whether the law should impute interest on payments intended to be alimony payments but that failed to meet strict statutory requirements.

In summary, it seems unlikely that any imputed interest rules would or should apply to payments made pursuant to divorce property settlements. Indeed, there is more reason now than ever why sections 71 and 215 should preempt this field. Property settlement payments can now qualify as alimony. If they do not, courts should not be asked to determine whether such payments are in the nature of "support" or "property settlement." DRTRA was designed to put an end to such questions.

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61. Although a property settlement transfer is treated as a gift for *income* tax purposes, a "gift loan" under I.R.C. § 7872 (CCH 1985) is a loan in which the foregone interest is "a gift for gift tax purposes." GENERAL EXPLANATION, *supra* note 2, at 529; H.R. REP. NO. 861, 98th Cong., 2d Sess. 1018 (1984), *reprinted in* 1984-3[2] C.B. 272. For gift tax purposes property settlements are not gifts. I.R.C. § 2516 (CCH 1985). Proposed and temporary regulations under I.R.C. § 7872 do not address the issue of whether § 7872 would apply to debt instruments from one spouse to another issued pursuant to divorce. Below-Market Loans, 50 Fed. Reg. 33,553 (1985) (to be codified as Treas. Reg. § 1.7872) (proposed August 20, 1985); Below-Market Loans, 50 Fed. Reg. 33,520 (1985) (to be codified as Treas. Reg. § 1.7872-5T).

## 2. *Interest Stated*

If a divorce property settlement agreement recites a sale of property for installment payments bearing a stated amount of interest, the amounts designated by the parties as interest should be treated as interest for tax purposes. Although taxable “sales” pursuant to divorce are not possible, the Code does not prohibit spouses or former spouses from lending money to each other. If the transaction is described as a sale, and interest is provided for, it is reasonable to treat the debt instruments as interest-bearing debts for tax purposes. If the interest stated is lower than the market rate of interest, interest should be imputed only to the extent provided in regulations issued under section 7872.<sup>62</sup>

## 3. *Caveat*

None of the issues regarding interest on installment sales between spouses can be considered to be settled. These issues were not considered by any committee involved in drafting the 1984 Tax Reform Act. Installment sales raise other unanswered questions. If one spouse receives installment notes pursuant to a divorce property settlement, a subsequent gift of those notes is presumably not a taxable disposition under section 453B, and the donee of the notes presumably reports no income as the notes are collected.<sup>63</sup> Also, if no interest is imputed to a spouse who sells to another spouse on the installment method, no interest should be imputed to a person to whom the selling spouse gives the installment notes.<sup>64</sup>

## C. *Assignment of Income Problems*

Fundamental tax principles dictate that earned income should be taxed to the person who earned it. Assignments of accounts receivable and of other

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62. Note that this would be the applicable federal rate rather than 120% of that rate. *See supra* note 54.

63. The basis of the obligee spouse in the installment notes should be considered to be equal to the face amount of those notes, since no income would be reported by her on collection of the notes. *See* I.R.C. § 453B(a)–(b) (CCH 1985).

64. The result would be different, however, if the selling spouse sells the installment notes at a discount. For example, assume that a wife receives \$100,000 face amount installment notes from her husband in a divorce property settlement. If the wife retains the notes and collects them as they fall due, she has no income. If she gives the notes to a child, the child presumably has no income upon collection of the notes. If she sells the notes to a third party for \$55,000, the third party should have interest income upon eventual collection of the notes of \$45,000. Presumably the wife would recognize a loss on this kind of sale, but it would appear to be a nondeductible personal loss. *See* I.R.C. § 165(c) (CCH 1985).



rights to earned income are not normally effective for tax purposes.<sup>65</sup> The 1984 Act raises the question of whether traditional assignment of income principles apply to assignments made pursuant to divorce. As already noted, assignments of installment obligations to a spouse incident to divorce can now operate to shift taxation of the gain to the transferee.<sup>66</sup> Also, the Retirement Equity Act of 1984 indicates that assignments of interests in qualified pension and profit-sharing plans will cause the assignee, rather than the assignor who earned the income, to be taxed on payments received.<sup>67</sup> It is still unclear whether such earned income items as accounts receivable and rights under nonqualified deferred compensation arrangements can be effectively assigned for tax purposes. Thus, a cash basis taxpayer who transfers an interest in accounts receivable to a spouse pursuant to divorce may still be taxed when those accounts are collected by the other spouse. To some extent these problems can probably be avoided by private agreement.<sup>68</sup>

## II. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS

### A. *General Requirements*

Payments that constitute "alimony" as defined in section 71 are included in the gross income of the payee spouse and are deductible by the payor spouse under section 215 as a deduction from gross income. "Alimony" is any cash payment<sup>69</sup> made under a divorce or separation instrument if

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65. *Lucas v. Earl*, 281 U.S. 111 (1930).

66. See *supra* note 45 and accompanying text.

67. Part or all of an employee's interest in a pension or profit sharing trust (or an individual retirement account) can be awarded to a nonemployee spouse pursuant to a qualified domestic relations order. I.R.C. § 414(p) (CCH 1985). The nonemployee spouse is taxed upon receipt of distributions. I.R.C. § 402(a)(9) (CCH 1985). See also I.R.C. § 408(d)(6) (CCH 1985) (individual retirement accounts).

68. It can be argued that traditional assignment of income principles should not apply to transfers of income items that are part of a property settlement. Support for this argument can be found in *Hempt Bros. v. United States*, 490 F.2d 1172 (3d Cir. 1974). In *Hempt* the court ruled that assignment of income principles should give way to the nonrecognition rules of I.R.C. § 351 where a partnership transferred its total business, including accounts receivable, to a controlled corporation. Section 1041 is a nonrecognition rule of at least the scope of § 351. Parties can thus take the position that the transferee of accounts receivable and of other income items should pay the tax on those items. The divorce or separation instrument could so state and could further provide that the transferee will hold the transferor harmless from tax liability on such items. Such a provision, while not binding on the Commissioner, would dissuade a transferee from attempting to exclude the accounts receivable. If the accounts receivable are reported by the transferee, it is not likely that the Commissioner would assert a deficiency against the transferor on the same item. See *Boucher v. Commissioner*, 710 F.2d 507, 512 (9th Cir. 1983) ("this court has recognized that the parties have considerable freedom in determining the tax consequences of their divorce through a negotiated property settlement").

69. Only payments of cash (including checks and money orders payable on demand) can qualify as alimony. Treas. Reg. § 1.71-1T(b)(Q & A 5) (1984).

certain further conditions are met. A “divorce or separation instrument” is a divorce or separate maintenance decree or written instrument incident thereto, a written separation agreement, or a decree, other than a divorce or separate maintenance decree, requiring one spouse to make payments for the support or maintenance of the other spouse.<sup>70</sup> The last type of decree consists chiefly of temporary support orders issued during the pendency of divorce or separate maintenance proceedings. Because payments made under this last type of decree are not subject to the “six-year” and “alimony recapture” rules,<sup>71</sup> it will be important to distinguish such decrees from other types of divorce or separation instruments.

Cash payments made pursuant to divorce or separation instruments are not alimony to the extent that the instrument states that the payment is not deductible by the payor and is not income to the payee.<sup>72</sup> Thus, if one spouse is to receive a lump-sum payment at the time of divorce and monthly payments thereafter, the lump-sum payment will not be alimony if the divorce or separation instrument states that the payment is not to be treated as alimony for income tax purposes.

If individuals are legally separated under a decree of divorce or separate maintenance, a payment cannot be alimony if the payor and payee spouse are members of the same household.<sup>73</sup> This provision discourages tax-motivated divorces in which incomes are equalized by means of alimony payments, with former spouses then filing as two single taxpayers with approximately equal incomes. Taxes can still presumably be saved by such arrangements,<sup>74</sup> but only if the former spouses maintain two separate households. For these purposes, one dwelling unit shared by two spouses is one household even if the spouses “physically separate themselves within the

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70. I.R.C. § 71(b)(2) (CCH 1985). These instruments are the same instruments as those described in § 71(a), prior to amendment by DRTRA. Treas. Reg. § 1.71-1T(a)(Q & A 4) (1984).

71. See I.R.C. § 71(f)(5)(B); see also *infra* notes 117–19 and accompanying text.

72. I.R.C. § 71(b)(1)(B) (CCH 1985). This provision acknowledges that if payments meet all of the formal requirements of alimony, the parties can agree which spouse will be taxed on the payments. The parties can designate that all, or part, of the payments shall be within the alimony framework. The agreement must be specified in the divorce or separation instrument and the payee must attach a copy of the instrument to his or her return as a condition of excluding the item.

73. I.R.C. § 71(b)(1)(C) (CCH 1985).

74. Because tax rates are lower for unmarried taxpayers than for married taxpayers (even if the married taxpayers file joint returns), taxes can be reduced if the aggregate income of a husband and wife can be divided equally between the same two persons who are unmarried. For example, the tax on a married couple with an income of \$60,000 is \$15,168 (1984 rates). The aggregate tax on two unmarried persons with a taxable income of \$30,000 each is \$12,226. If one spouse were a head of household, the aggregate tax would be \$11,807. See I.R.C. § 1 (CCH 1985). By careful planning, two taxpayers could equalize incomes by means of alimony paid pursuant to divorce. The intractable problem of how to tax the family is discussed in Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389 (1979). See also Gann, *Abandoning Marital Status as a Factor in Allocating Income Tax Burdens*, 59 TEX. L. REV. 1 (1980).

dwelling unit.”<sup>75</sup> On the other hand, spouses are not considered members of the same household if at the time of payment one spouse is preparing to depart from the household and does so within one month from the date the payment is made.<sup>76</sup>

A final general requirement is that there can be no requirement to make any payment for any period after the death of the payee spouse.<sup>77</sup> Moreover, the divorce or separation instrument must state that there is no such requirement.<sup>78</sup> A divorce or separation instrument will not be treated as stating that there is no liability to make payments after the death of the payee spouse merely because the liability to pay terminates under local law or by oral agreement.<sup>79</sup> For example, payments made under a temporary support order will not constitute alimony for tax purposes unless the order states that there is no liability to make any payments for any period after the death of the payee spouse. There can also be no liability to make any payment (or to transfer any property) as a substitute for alimony payments after the death of the payee spouse.<sup>80</sup> On the other hand, it is permissible to require a payor to pay insurance premiums on the payee's life,<sup>81</sup> and if the payee owns the policy, the payments of premiums by the other spouse might even constitute alimony payments.<sup>82</sup>

The requirement that there be no requirement to make any payment after the death of the payee spouse is one of the objective tests designed to prevent taxpayers from deducting the cost of property purchased from a spouse pursuant to divorce. A spouse who has a substantial property interest is less likely to transfer that interest for alimony payments if those payments must terminate on her or his death. Also, it seems reasonable to ask that the divorce or separation instrument recite such lack of obligation in order to eliminate uncertainty caused by the vagueness of local law. Until this requirement becomes generally known, however, many innocent taxpayers will be adversely affected if their counsel (or the divorce judge) are unaware of what may appear to be a needless requirement. It would therefore be appropriate to eliminate this requirement for payments made

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75. Treas. Reg. § 1.71-T(b)(Q & A 9) (1984).

76. *Id.*

77. I.R.C. § 71(b)(1)(D) (CCH 1985).

78. *Id.*

79. Treas. Reg. § 1.71-IT(b)(Q & A 12) (1984).

80. The divorce or separation instrument need not recite that there is no liability to make substitute payments. Treas. Reg. § 1.71T(b)(Q & A 13) (1984).

81. “Amounts payable under a life insurance contract on the life of the payee spouse will not be treated as a liability which would affect the status of other payments made by the payor spouse.” GENERAL EXPLANATION, *supra* note 2, at 715.

82. Payments made to a third party (e.g., an insurance company) on behalf of a spouse may qualify as alimony, provided that the insured spouse is the owner of the insurance policy. Treas. Reg. § 1.71-IT(b)(Q & A 6) (1984).

pursuant to temporary support orders that are not divorce or separate maintenance decrees.

### *B. Payments to Support Children*

Prior to 1984, alimony did not include “that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the [payor].”<sup>83</sup> The regulations interpreted this language to mean that if payments were received by the payee for the support and maintenance of the payee and of minor children of the payor “without . . . specific designation of the portion for the support of such children,” all payments received would constitute alimony.<sup>84</sup> The Supreme Court went even further, holding that payments could constitute alimony even if they were reduced or terminated upon the emancipation of a child, or upon some other occurrence relating to a child.<sup>85</sup>

The 1984 Act continues to exclude child support payments from the definition of alimony,<sup>86</sup> but adds a further provision that if any payment will be reduced “on the happening of a contingency . . . relating to a child . . . or at a time which can clearly be associated with” the happening of such a contingency, then the amount of such reduction will be treated as nondeductible child support.<sup>87</sup> This language is clearly designed to reverse the rule established by the Supreme Court in the *Lester* case. In *Lester*, payments were to be reduced by one-sixth in the event that any of the three children of the parties “marry, become emancipated, or die.” The Commissioner asserted that under these facts one-half of the payments were intended as child support and should be so treated. The Supreme Court disagreed, stating that payments are not child support payments for tax purposes unless specifically so designated, and should not be “left to determination by inference or conjecture.”<sup>88</sup> Although it is clear that payments of the type involved in the *Lester* case will now be treated as nondeductible child support, there is much that is not clear.

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83. Internal Revenue Code of 1954, ch. 736, § 71(b), 68A Stat. 19, *amended by* Tax Reform Act of 1984, Pub. L. No. 98-389, § 422(a), 93 Stat. 494, 795. Almost identical language can now be found in I.R.C. § 71(c)(1) (CCH 1985).

84. “If . . . the . . . payments are received by the wife for the support and maintenance of herself and of minor children of the husband without . . . specific designation of the portion for the support of such children, then the whole of such amounts is includible in the income of the wife . . . .” Treas. Reg. § 1.71-1(e) (1957).

85. *Commissioner v. Lester*, 366 U.S. 299 (1961).

86. I.R.C. § 71(c) (CCH 1985).

87. I.R.C. § 71(c)(2) (CCH 1985).

88. *Commissioner v. Lester*, 366 U.S. at 306.

First, the new provision, section 71(c)(2), applies only if a payment will be "reduced" upon the occurrence of a contingency relating to a child. The provision does not literally apply to payments that will "terminate" upon the occurrence of such an event.<sup>89</sup> For example, if a person is ordered to pay a former spouse \$1000 per month until their only child becomes eighteen, and \$500 per month thereafter, \$500 of each payment is nondeductible child support. But if that person is instead ordered to pay the former spouse \$1000 per month until their only child becomes eighteen, and nothing thereafter, there is arguably no "reduction" in a payment and the entire amount might be treated as deductible alimony. A sensibly drafted statute would apply to terminations as well as reductions, but new section 71(c)(2) is not sensibly drafted. The provision was added by the conference committee without prior hearings or debate and is predictably inadequate. It can be appropriately argued that the reasoning of the *Lester* case still applies to payments that terminate upon the occurrence of a contingency relating to a child. Legislative oversights caused by irregularities in the legislative process should not be cured by the courts.<sup>90</sup>

Second, section 71(c)(2) also provides that a payment will be treated as nondeductible child support to the extent that it will be reduced at a time that can "clearly be associated with" a contingency relating to a child.<sup>91</sup> A payment that is to be reduced when a child becomes eighteen, marries, or dies is nondeductible child support to the extent of the potential reduction because becoming eighteen, marrying, or dying is a contingency relating to a child.<sup>92</sup> A reduction scheduled to occur on a specified date that happens to be the same date as the date of the eighteenth birthday of a child (but that does not refer to the child's birthday) can clearly be associated with a contingency relating to a child and would normally be nondeductible child support. In many circumstances, unfortunately, it will not be clear whether a reduction in payments is clearly associated with a contingency relating to a child. Temporary regulations set forth two circumstances under which reductions in payments will be presumed to be associated with a contingency relating to a child. In all other circumstances reductions will not be considered to be clearly associated with a contingency relating to a child.

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89. The statute uses only the term "reduced." The same is true of the REPORT OF THE CONFERENCE COMMITTEE, H.R. REP. NO. 861, 98th Cong., 2d Sess. 1117 (1984), *reprinted in* 1984-3[2] C.B. 371 [hereinafter cited as CONFERENCE REPORT]. The explanation prepared by the Staff of the Joint Committee on Taxation also uses the term "reduced." GENERAL EXPLANATION, *supra* note 2, at 715.

90. The oversight is not cured by the regulations, which refer only to reductions, and not to terminations. Treas. Reg. § 1.71-1T(c)(Q & A 16) (1984).

91. I.R.C. § 71(c)(2)(B) (CCH 1985).

92. Treas. Reg. § 1.71-1T(c)(Q & A 17) (1984).

The first circumstance applies when payments are to be reduced at a time not more than six months before or after a child is to attain the local age of majority. If there is only one reduction and it occurs at some specified date that is not within the period specified, the reduction is conclusively presumed *not* to be clearly associated with a contingency relating to a child.<sup>93</sup> For example, if a married couple has one child born on June 1, 1975, and one spouse is ordered to pay the other spouse \$2000 per month until July 1, 1993, and \$1000 per month thereafter, \$1000 of each payment is presumed (rebuttably) to be clearly associated with the child becoming eighteen years of age on June 1, 1993. But if the payor spouse is instead ordered to pay \$2000 per month until February 1, 1994, and \$1000 per month thereafter, no part of any payment is considered to be child support. Parents who have only one child can easily cause intended child support to be taxed as alimony, but such arrangements could be unwise. If one spouse agrees to pay a fixed monthly sum to another spouse until a date not specifically tied to a contingency relating to a child, the obligation to pay continues even if the payor becomes the custodial parent, or the child marries or dies before becoming eighteen.

The second circumstance occurs when there are two or more reductions and two or more children. The temporary regulations state that this second circumstance occurs

where the payments are to be reduced on two or more occasions which occur not more than one year before or after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. The certain age referred to in the preceding sentence must be the same for each such child, but need not be a whole number of years.<sup>94</sup>

While the regulation may be a reasonable interpretation of the statute, it is unintelligible and should be rewritten. The regulation might be rephrased as follows:

If payments are to be reduced on two or more occasions, and if there are two or more children, the reductions will be presumed to be clearly associated with a contingency relating to a child if (i) at least one reduction occurs at a time when a child is between the ages of eighteen and twenty-four, and (ii) the disparity in the ages of the children at the times at which reductions occur is two years or less.

For example, if one reduction occurs when the elder of two children is twenty-three and the second occurs when the younger is at least twenty-one

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93. Treas. Reg. § 1.71-1T(c)(Q & A 18) (1984).

94. Treas. Reg. § 1.71-1T(c)(Q & A 18) (1984).

but not more than twenty-five, the amount of each reduction is nondeductible child support. But if the second reduction occurs when the younger child is less than twenty-one or more than twenty-five, no part of any payment would be considered to be child support as long as neither reduction occurs within six months from the time any child attains eighteen, twenty-one, or the local age of majority.<sup>95</sup> The reasoning of the regulation may be somewhat as follows: If there are two children and payments are reduced when each child attains a stated age (e.g., twenty) between eighteen and twenty-four, it is reasonable to assume that the payments are child support. If the ages at which the reductions occur are not identical, but are relatively close together, the same rule applies. But if the disparity in ages at which reductions occur exceeds two years, it is reasonable to assume that the payments are *not* child support.

This new “anti-*Lester*” provision may be illustrated by the following examples:

*Example 1:* Husband and Wife have two children. Son was born on January 1, 1975, and Daughter was born on May 1, 1976. The local age of majority is either eighteen years or twenty-one years. Husband is ordered to pay Wife \$2000 per month until January 1, 1995, and \$1000 per month thereafter until Wife dies or remarries. Because there is only one reduction, and because it occurs when Son is twenty years of age and Daughter is eighteen years and seven months of age, no part of any payment is considered to be nondeductible child support. There is only one reduction and it does not occur within six months from the time a child becomes eighteen, twenty-one, or the local age of majority.

*Example 2:* Same husband and wife and same children (children born on January 1, 1975, and May 1, 1976). Husband is ordered to pay Wife \$3000 per month until January 1, 1995, \$2000 per month thereafter until January 1, 1998, and \$1000 per month thereafter. Under these circumstances only \$1000 per month could be considered to be alimony. The first reduction (January 1, 1995) occurs when Son is twenty years old. The second occurs when Daughter is twenty-one years and eight months old. The disparity in ages at which the reductions occur is less than two years.

*Example 3:* Same as *Example 2* except that the first reduction occurs on January 1, 1995 (when Son is twenty years old), but reduced payments continue until June 1, 1998, when Daughter is twenty-two years and one month old. Because the disparity in ages at which the reductions occur is more than two years, no part of any payment is considered child support.

*Example 4:* Same husband and wife and same children. Husband is ordered to pay Wife \$2000 per month until January 1, 1995 (when Son is twenty and

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95. See Treas. Reg. § 1.71-1T(c)(Q & A 18)(example) (1984).

Daughter is eighteen years and seven months old) and \$1000 per month thereafter until January 1, 1998 (when Son is twenty-three and Daughter is twenty-one years and eight months). If the termination of payments on January 1, 1998, is a "reduction," then all payments are nondeductible child support, because the disparity in ages at which reductions occur is less than two years. If the termination of payments is not a reduction, then no part of any payment constitutes child support, because there is no reduction occurring within six months from the time a child becomes eighteen, twenty-one, or the local age of majority. In my opinion the word "reduce" does not include the word "terminate," but the matter is not free from doubt.

If part or all of certain payments are presumed to be clearly associated with a contingency related to a child, the presumption can be rebutted by showing a different purpose for the reduction. The temporary regulations state that the presumption will be "rebutted conclusively" if the reduction is "a complete cessation of alimony or separate maintenance payments during the sixth post-separation year" or "upon the expiration of a 72-month period."<sup>96</sup>

It is possible that clever lawyers will still be able to disguise child support as alimony. It is more probable that many lawyers who make such attempts will fail because of their failure to comprehend or to apply the tests set forth in the regulations. It is certain that many persons who have no thought of disguising child support payments as alimony will be trapped because of a hasty and unwise provision adopted by Congress without any apparent discussion or debate. For example, assume that a couple has two children, one fifteen and one sixteen. One spouse is ordered to pay the other spouse \$800 per month for three years. Payments will terminate when the younger child is eighteen years and three months old. Under temporary regulations, it is *possible* that the termination will be held to be a reduction and that the payments will be presumed to be child support because the reduction occurs within six months from the time a child becomes eighteen. The payor can probably rebut the presumption and may therefore deduct the payments. The payee would be justified in accepting the presumption and in excluding the payments from income. That is, one party would deduct payments the other party does not report, and no one can say which party is correct until the matter is litigated. This new provision therefore encourages the kind of inconsistent reporting and administrative difficulty the 1984 provisions were supposed to eliminate.

In the *Lester* case, the Supreme Court left the question of which parent should bear the burden of tax on child support payments to the parties involved. It is not clear why the *Lester* rule was rejected in 1984. It is

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96. *Id.* The regulation just quoted implies that a termination of payments is a reduction, but makes no such direct assertion.



possible that the rule was rejected because such a rule would exacerbate problems under the "six-year rule" and "alimony recapture rule" described below.<sup>97</sup> If those rules are abolished, the *Lester* rule can be reinstated without these difficulties. It does not seem unreasonable to permit parents to decide which parent should bear the tax burden on child support payments.

### C. *Excess Front-Loading of Alimony Payments*

Section 71(f) contains provisions designed to prevent "excess front-loading" of alimony payments. If the period during which payments are made is too short, no more than \$10,000 per year may be deducted.<sup>98</sup> If the payment period is sufficiently long, but payments are reduced substantially in a later year or years in the period, the payor must report part of the reduction as income.<sup>99</sup> The payment period with which section 71(f) is concerned is a period that includes six consecutive calendar years beginning with the first calendar year in which the payor pays alimony or separate maintenance payments. Temporary support payments made under section 71(b)(2)(c) cannot be counted.<sup>100</sup> Each year in the period is referred to as a "postseparation year," even though the first year in the period will often be the year in which the decree of divorce or separate maintenance is issued, and could be an earlier year.<sup>101</sup> The first and last years in the period need not be complete years. For example, if a payor is ordered to pay alimony of \$1000 per month for fifty months, commencing on December 31, 1985, and ending on January 1, 1990, payments are made in each of the six postseparation years beginning with 1985, even though only one monthly payment is made in 1985 and 1990.<sup>102</sup>

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97. If the *Lester* rule were reinstated, but the alimony recapture rules of I.R.C. § 71(f)(2) were retained, reductions in payments occurring when a child becomes eighteen could generate alimony recapture. Also, if payments are to terminate when a child becomes eighteen, marries, or dies (and the termination is considered a reduction), the requirement that payments be made in at least six postseparation years could not be met. See *infra* notes 103-12 and accompanying text.

98. I.R.C. § 71(f)(1) (CCH 1985).

99. I.R.C. § 71(f)(2) (CCH 1985).

100. I.R.C. § 71(f)(5)(B) (CCH 1985). If one spouse makes 36 monthly payments under a temporary support order and 40 monthly payments under a divorce decree, the two cannot be joined to determine whether the spouse has made payments in each of six postseparation years.

101. For example, payments made pursuant to a written separation agreement are considered to be made in a "postseparation year." See Treas. Reg. § 1.71-1T(d)(Q & A 22) (1984).

102. *Id.* The regulations are a reasonable interpretation of the statute, even though the legislative history suggests that full years were intended. See General Explanation, *supra* note 2, at 716; CONFERENCE REPORT, *supra* note 89, at 1117.

### 1. *The Six-Year Rule*

The first barrier to front-loading provides that alimony or separate maintenance payments in excess of \$10,000 per year are not to be treated as alimony or separate maintenance unless some payments are to be made in each of the six postseparation years, disregarding terminations that may occur on the death of either spouse or remarriage of the payee spouse. Amounts up to \$10,000 can be alimony or separate maintenance even if payments are to be made for a shorter period.<sup>103</sup> To illustrate:

A is ordered to pay B \$1500 per month, commencing on December 1, 1985, and continuing for forty-two consecutive months, with the last payment to be made on May 1, 1989, or on the earlier death of the payee spouse. A is thus required to pay \$1500 in 1985, \$18,000 in each of the years 1986–88, and \$7500 in 1989.

A can deduct the full \$1500 paid in 1985. A can also deduct the full \$7500 paid in 1989. A can deduct only \$10,000 of the \$18,000 paid in each of the years 1986–88.

It is very easy to avoid the barrier of this six-year rule by providing for nominal payments. In the preceding example, the six-year rule could be met by providing for an additional maintenance payment of one dollar in 1990.<sup>104</sup> Payments would then be made in each of the six years 1985 through 1990. But the payor would then encounter the alimony recapture rule of section 71(f)(2).

### 2. *Alimony Recapture*

The alimony recapture rule exhibits narrow technical ingenuity but very little wisdom, judgment, or common sense. The tax laws relating to divorce must be understood by lawyers and judges who are not necessarily tax specialists. Those laws should also be understood by—and should make sense to—people who are subject to them. Divorced people include many persons who are not sophisticated in matters of tax and finance. It seems fair to assume that a large number of lawyers, judges, and taxpayers who must apply and live with the alimony recapture rules will not understand them. Even when properly understood and correctly applied, the rules can work great mischief. This misunderstanding and mischief might be tolerable if the rule accomplished its intended purpose, but it does not.

The alimony recapture rule is contained in section 71(f)(2) and (3). It provides that if payments in a later year in the six-year postseparation

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103. Treas. Reg. § 1.71-1T(d)(Q & A 20) (1984).

104. Treas. Reg. § 1.71-1T(d)(Q & A 23) (1984).

period decline by more than \$10,000 when compared with any earlier year in such period, the payor of alimony must report as income the amount by which such decline exceeds \$10,000. The recipient of alimony can deduct a like amount.<sup>105</sup> Stated somewhat differently, the amount "recaptured" in the computation year is the amount by which payments in a prior year exceed the sum of computation year payments plus \$10,000.<sup>106</sup>

For example, if *A* is required to and does pay *B* \$25,000 in the first post-separation year and \$8000 in all succeeding years in the period, *A* deducts \$25,000 in the year of payment but must recompute the alimony deduction in the second year. The recomputation is accomplished by adding \$10,000 to payments made in the computation year and subtracting that sum from the payment made in the immediately preceding year. In this example, *A* would, in the second year, add \$10,000 to the \$8000 paid in that year and then subtract \$18,000 from the \$25,000 paid in the first year. The difference, \$7000, is added to *A*'s income in the recomputation year and is deductible by the payee in determining adjusted gross income.<sup>107</sup> A computation must be made for all succeeding years in the six-year period,<sup>108</sup> and it must be made by comparing payments in the computation year with payments in all preceding years.

To prevent multiple recapture, the amount paid in any prior year is reduced by alimony previously recaptured for that year. In the preceding example, the payment in the first year (\$25,000) is deductible but generates \$7000 of alimony recapture in the second year.<sup>109</sup> In the third year a computation must be made by comparing the payment made in the third year (\$8000) with payments made in the first two years. Because the payment made in the second year (\$8000) does not exceed the payment made in the third year (\$8000), there is no recapture in respect of the second year. Because the payment made in the first year (\$25,000) is reduced by

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105. Although the deduction of the payee is not specifically listed in I.R.C. § 62, the amount is deductible in "computing adjusted gross income." I.R.C. § 71(f)(2)(B) (CCH 1985). The deduction can thus be claimed even if the payee does not itemize deductions. In computing a net operating loss, however, the deduction can be claimed only to the extent of nonbusiness income. I.R.C. § 172(d) (CCH 1985). If the recapture amount is substantial, a large part of the deduction may be lost. Assume, for example, that *A* pays *B* alimony of \$20,000 per year for five years and pays nothing in the sixth year because of default. If *A* was able to deduct all payments in the first five years, *A* will have \$50,000 of recapture income in year six under these facts. *B* has an offsetting deduction. But *B* can apply the deduction only to the extent of nonbusiness income received during the year. If *B*'s only other income is a salary of \$15,000, only \$15,000 of *B*'s deduction can be utilized for any purpose. It is therefore usually extremely unwise to stage a deliberate recapture situation in order to accelerate front-end deductions because the recapture income burden of the payor will often not be offset by a deduction that the payee can utilize.

106. I.R.C. § 71(f)(3) (CCH 1985).

107. I.R.C. § 71(f)(2) (CCH 1985).

108. I.R.C. § 71(f)(3)(B) (CCH 1985).

109. *Id.*

the amount previously recaptured for that year (\$7000), the reduced figure (\$18,000) does not exceed the payment made in the third year by more than \$10,000, and there is no recapture.<sup>110</sup> There is no recapture for declines in payments attributable to the death of either spouse or the remarriage of the payee spouse<sup>111</sup> in the postseparation period or to declines occurring after the end of the sixth postseparation year.<sup>112</sup>

The application of the alimony recapture rules may be illustrated by the following examples, all of which involve total payments of \$150,000.

*Example 1:* A is ordered to pay to B the following amounts in the six post-separation years: \$50,000; \$40,000; \$30,000; \$20,000; \$10,000; and \$0.

Because A is required to make payments in five years only, A can deduct no more than \$10,000 per year. Only \$50,000 of the \$150,000 paid can be deducted.

*Example 2:* A is ordered to pay B the following amounts in the six post-separation years: \$50,000; \$40,000; \$30,000; \$20,000; \$10,000; and \$1.

All payments are initially deductible by A and are income to B. Recapture in year two is zero because the year one payment does not exceed the year two payment by more than \$10,000. Recapture in year three is \$10,000 (zero from year two but \$10,000 from year one because the year one payment exceeds the year three payment plus \$10,000 by \$10,000). The year three recapture reduces the year one payment for purposes of further recapture by \$10,000, down to \$40,000. Recapture in year four is \$20,000 (zero from year three but \$10,000 from each of year two and year one). Payments made in each of years one and two are reduced, for purposes of further recapture, to \$30,000 per year. Recapture in year five is \$30,000 (zero from year four but \$10,000 from each of years three, two, and one). Payments in years one, two, and three are reduced, for purpose of further recapture, to \$20,000 per year. Recapture in year six is \$39,996 (zero from year five, but \$9999 from each of years one through four, the amount by which payments in those years, as reduced by prior recapture, exceed \$10,001). In sum, recapture amounts are \$10,000 (year three); \$20,000 (year four); \$30,000 (year five); and \$39,996 (year six), or \$99,999 in all. The result here is much the same as if no payment had been made in year six. The net deduction for A in both cases is about \$50,000, but by coming within the recapture rules, A was able to accelerate deductions.

*Example 3:* A is ordered to pay B the following amounts in the six post-separation years: \$35,000; \$35,000; \$35,000; \$15,000; \$15,000; and \$15,000.

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110. See Treas. Reg. § 1.71-1T(d)(Q & A 24) (1984).

111. I.R.C. § 71(f)(5) (CCH 1985); Treas. Reg. § 1.71-1T(d)(Q & A 25) (1984).

112. A "recomputation" is required only for a "computation year," which is any year in the "six calendar year period beginning with the first calendar year in which the payor spouse pays the payee spouse alimony or separate maintenance payments." I.R.C. § 71(f)(4) (CCH 1985).

All payments are initially deductible by *A* and income to *B*. There is \$30,000 of recapture in year four. The payment in each preceding year exceeds the year four payment by \$20,000. The amount recaptured for each prior year is the amount by which the decline exceeds \$10,000 for each such year. Stated somewhat differently, payments in each prior year exceed the sum of year four payments plus \$10,000 by precisely \$10,000, and there are three prior years for which computations must be made. For purposes of further recapture, payments in years one through three are reduced to \$25,000 per year to reflect prior recapture. So reduced, the payments in such years do not exceed payments in years five and six by more than \$10,000, so there is no further recapture. The total amount recaptured is thus \$30,000.

### 3. *Recapture Caused by Defaults*

Alimony recapture amounts are determined by reference to amounts actually paid (rather than by amounts required to be paid).<sup>113</sup> A default in payments can cause alimony recapture.<sup>114</sup> Payments of alimony arrearages can apparently cause further recapture. For example, if *A* is ordered to pay *B* \$20,000 per year for six years, a complete default by *A* in year four would cause *A* to have \$30,000 of recapture income and *B* would have a \$30,000 deduction. If *A* pays the arrearage in year five plus the \$20,000 due in that year, the total payment in year five would be \$40,000 and recapture in year six would be \$10,000. This result has a "double recapture" effect, in that the payment of arrearages can itself generate further recapture.<sup>115</sup> If the new provision discourages payment defaults, it also appears to discourage payments of alimony arrearages.

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113. See I.R.C. § 71(f)(3) (CCH 1985).

114. A payor cannot avoid this result by issuing a note for the defaulted amount because alimony is deductible only if paid in cash (including checks and money orders payable on demand). Treas. Reg. § 1.71-1T(b)(Q & A 5) (1984). A payor who transfers property, such as real estate or the obligation of a third party, in discharge of an alimony obligation cannot obtain a deduction for alimony and may even be liable for alimony recapture. In addition, if the transfer is not considered to be a transfer "incident to divorce," the transferor might recognize gain under the general reasoning of *United States v. Davis*, 370 U.S. 65 (1962). For example, if *X* is ordered to pay *Y* \$26,000 per year for six years and transfers to *Y*, in year six, appreciated property having a basis of \$8000, *X* has no deduction in year six, and alimony "recapture" income of \$80,000. If the transfer is held to be *not* "incident to divorce," *X* would also have a gain of \$18,000. Remember also, that the deduction of *Y* (\$80,000) cannot give rise to a net operating loss deduction, *see supra* note 105, so that if *Y*'s income in year six is low, the tragedy visited on *X* bestows very little benefit on *Y*.

115. While the result is harsh, it is a logical necessity under the recapture rules. In the example given in the text, total payments are \$120,000. *A* is taxed on \$40,000 of that amount because \$120,000 is deducted and \$40,000 is "recaptured." *B* reports \$120,000 but gets recapture "deductions" of \$40,000, so that *B*'s net income is \$80,000. Thus, of the total income of \$120,000, only \$80,000 is taxed to *B* (assuming *B* can utilize recapture deductions). The remaining \$40,000 is taxed to *A* under the recapture rules of I.R.C. § 71(f) (CCH 1985).

The recapture problem presented by alimony arrearages is aggravated if a payor spouse is required to pay both alimony and child support. If the annual payments made are less than the total of all payments required to be made, payments are treated as made first for child support until all child support payments are made.<sup>116</sup> Only payments in excess of required child support can be alimony. Thus, if one spouse is required to pay child support of \$18,000 per year and alimony of \$20,000, a payment of only \$20,000 in a "computation year" would trigger alimony recapture because only \$2000 of the \$20,000 would be considered to be an alimony payment.

One should remember, of course, that the "six-year rule" and "alimony recapture rule" apply only if, and to the extent that, alimony payments exceed \$10,000 per year. The rules present significant problems only if payments in excess of \$10,000 per year are ordered with a fair degree of frequency. There is no evidence that Congress devoted any serious attention to this issue. It is at least plausible that "rehabilitative alimony" of relatively large amounts for relatively short periods of time would be frequent, especially where one spouse has not been in the work force for a long period of time and needs support during a period of retraining. One can sympathize with an attorney who attempts to explain to a client why only \$10,000 of annual alimony payments are deductible, even though they are clearly intended to support the payee.<sup>117</sup>

#### 4. *Exception for Temporary Support Payments*

Section 71(f)(5)(B) provides that temporary support order payments are not "alimony or separate maintenance payment[s]" for purposes of subsection 71(f), relating to the six-year rule and alimony recapture rule. Such

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116. I.R.C. § 71(c)(3) (CCH 1985).

117. The House bill was not much better than the bill Congress eventually approved. Although the House bill did not repeal *Commissioner v. Lester*, 366 U.S. 299 (1961), and did not require that the divorce or separation instrument specifically state that alimony is not payable for any period after the death of the payee, it did contain a recapture rule. That recapture rule operated as follows: If alimony payments in year one exceed by more than \$15,000 the average of alimony payments made in year two and year three, the excess amounts would be recaptured in year three; and if alimony payments in year two exceed year three alimony payments by more than \$15,000, the excess amount is recaptured in year three. For example, if payments in years one, two, and three are \$90,000, \$60,000, and \$30,000 respectively, recapture from year one is \$30,000 (the first year payment of \$90,000 exceeds the average of year two and year three payments plus \$15,000 by \$30,000). Recapture from year two is \$15,000 (the year two payment of \$60,000 exceeds the year three payment plus \$15,000 by \$15,000). The total recapture amount is \$45,000. See REPORT OF HOUSE WAYS AND MEANS COMM. ON H.R. 4170, H.R. REP. NO. 432, 98th Cong., 2d Sess. 1496 (1984). While this proposal may have created less hardship than the final provision, it can hardly be said to be less complex. Moreover, the Bill does not have the excuse of being drafted in haste. It appears to have been the result of prolonged consideration by a group of experts from the American Bar Association Section on Taxation and "other tax and nontax attorneys specializing in the subject area." Law professors were included. See O'Connell, *supra* note 15, at 475, 493.

payments also cannot be counted in applying the six-year rule or alimony recapture rules. For example, if a temporary support order requires *A* to pay *B* maintenance of \$18,000 per year for three years and a later divorce decree requires *A* to pay *B* maintenance of \$20,000 per year for three succeeding years, the first three years could not be counted in determining the number of years in which *A* is required to make payments. Consequently, only \$10,000 could be deducted by *A* in the three years to which the divorce decree applies.

### 5. *Exception for Fluctuating Payments*

The alimony recapture rule does not apply to payments made "pursuant to a continuing liability (over a period of not less than six years) to pay a fixed portion of the income from a business or property or from compensation for employment or self-employment."<sup>118</sup> If the payment period extends for at least six years, the alimony recapture rule would be avoided. Payments defined as a fixed portion of compensation from employment or a fixed portion of income from property would therefore not lead to alimony recapture resulting from loss of employment or from a decline in income from property. Payments, however, must be made "over a period of not less than six years." Thus, the exception for fluctuating payments would not appear to apply to payments made for less than six years, even though some payments were made in each of the six post-separation years. Such payments would be subject to the six-year rule and the alimony recapture rule.<sup>119</sup>

Payment of a fixed percentage of wages with a maximum (or minimum) stated payment would not seem to qualify as payment of a "fixed portion." Also, payment of a fixed portion until a specified amount is paid would not seem to qualify. For example, a decree requiring one spouse to pay the other spouse all dividends on stock owned by the payor until \$100,000 had been paid would not be payment of a "fixed portion of the income from

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118. I.R.C. § 71(f)(5)(C) (CCH 1985).

119. *Id.* The language seems to contemplate that payments must be payable over a period of at least 72 months (and not a period that includes six calendar years). The temporary regulations state, however, that the exception applies "over the period of the postseparation years," thus implying that the period is the same as the period required in I.R.C. § 71(f)(1). Treas. Reg. § 1.71-1T(d)(Q & A 25) (1984). For example, a divorce decree orders *A* to pay 30% of his take-home pay to *B* for a period of 50 months. If the period starts on September 1st, payments would not be made in six postseparation years, and *A* could not deduct more than \$10,000. If, on the other hand, payments commence on December 15, 1985, and end on January 15, 1990, the six-year requirement of section 71(f)(1) would be met. But substantial declines in payments (and a substantial decline could be expected in 1990 because only one monthly payment is made that year) might trigger alimony recapture.

. . . property” because it cannot be determined that payments are to be made for a period of at least six years.

### III. ALIMONY TRUSTS

#### A. *In General*

Alimony trusts are an alternative to alimony payments as a means of providing for the support of a former spouse, and tax consequences are similar. In the case of alimony, the income is first included in the gross income of the payor, who deducts payments that the payee must report as income. If the payor instead transfers property to a trust, some or all of the income of which is distributable to the payee, the income distributed to the payee is not ordinarily included in the gross income of the payor, and a deduction is not needed.<sup>120</sup>

Prior to adoption of the 1984 Act, alimony trusts were not popular.<sup>121</sup> First, the transfer of appreciated property to an alimony trust could be a taxable event under the *Davis* rule.<sup>122</sup> Second, amounts distributed from trusts created pursuant to divorce could be taxed to the payee even if the trust had no income or less income than the amount distributed.<sup>123</sup> Finally, there were few tax reasons to use alimony trusts because the alimony rules made it very easy to shift income from one spouse to another.

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120. See I.R.C. §§ 215(d), 682 (CCH 1985). Under prior law, it was clear that if the trust was created pursuant to the divorce the beneficiary was taxed on all receipts from the trust (whether from income or principal) under I.R.C. § 71. It was also clear that if the trust was created prior to divorce or separation, income distributable to a former spouse was taxable to such spouse as beneficiary of the trust to the extent distributions came out of trust income. I.R.C. § 682 (CCH 1985). Section 682 applied to trusts that would otherwise have been grantor trusts under I.R.C. §§ 671-77. See S. REP. NO. 1631, 77th Cong., 2d Sess. (1942), reprinted in 1942-2 C.B. 504, 568; see also H.R. REP. NO. 2333, 77th Cong., 2d Sess. (1942), reprinted in 1942-2 C.B. 372, 409-10. One case held, erroneously, that the beneficiary of an alimony trust had no income if the income of the trust consisted of tax-exempt bond income. *Ellis v. United States*, 416 F.2d 894 (6th Cir. 1969). Previously, a spouse was taxed on periodic payments “attributable to property transferred in trust or otherwise.” Internal Revenue Code of 1954, ch. 736, 68A Stat. 1, 19. No exclusion was granted because payments were from principal or from tax-exempt income. Treas. Reg. § 1.71-1(c)(2) (1957) (stating that trust payments were income to the recipient “regardless of the source of the payments” was a reasonable interpretation of the statute and should not have been overruled).

121. Some of the reasons are set forth in Hjorth, *Tax Consequences of Post-Dissolution Support Payment Arrangements*, 51 WASH. L. REV. 233, 259 (1976).

122. The Commissioner ruled that if the transfer completely discharged the transferor’s obligation of support under prior law, it was taxable. Rev. Rul. 57-507, 1957-2 C.B. 511. The Tax Court indicated that the trust would not get a cost basis in the property, even if the transferor was taxed, if there was a gift of the remainder interest (or reversion) in the grantor. See *Spruance v. Commissioner*, 60 T.C. 141, 155 n.7 (1973).

123. See *supra* note 120.



One can expect that alimony trusts will become more popular under the new rules. Transfers of appreciated property to alimony trusts will not generate taxable gain. Also, amounts paid to the beneficiary of an alimony trust will be taxable only to the extent payments are made from trust income.<sup>124</sup> Another important consideration is that alimony trusts can be used to avoid the six-year rule and the alimony recapture rule, and might even be used to shift the tax burden on amounts used to support minor children.

### *B. Grantor Trusts and Alimony Trusts*

Trust income distributed to a beneficiary other than the settlor of the trust is taxed to the beneficiary unless the settlor is treated as the "owner" of part or all of the trust property.<sup>125</sup> Settlor is treated as owner if the trust is revocable,<sup>126</sup> the trust has a duration of less than ten years or a duration of less than the lifetime of the beneficiary,<sup>127</sup> the settlor retains the power to determine who shall enjoy principal and income of the trust,<sup>128</sup> the settlor retains broad administrative powers,<sup>129</sup> or income of the trust can be paid to the settlor or can be used to satisfy a legal obligation of the settlor.<sup>130</sup> Absent a special statute making these rules inapplicable, settlors would usually be treated as owners of alimony trusts because the income of such trusts is, almost by definition, used to satisfy a legal obligation of the settlor. Such trusts might also often be short-term trusts, or the grantor might retain the kinds of powers over the enjoyment of trust property that would cause the grantor to be taxed as an owner.

Section 682 steps in, however, to provide that a person divorced, legally separated, or separated under a written separation agreement who receives distributions from an alimony trust shall be taxed on trust distributions that, except for section 682, would be taxed to the settlor. The statute adds that "such amount shall not, despite any other provision of this subtitle, be includible in the gross income of [the settlor spouse]."<sup>131</sup> This provision

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124. Under old § 71, a beneficiary spouse of a trust created pursuant to divorce was taxed on all payments, whether from trust income or trust principal. Treas. Reg. § 1.71-1(c)(2) (1957). Today, I.R.C. § 71 does not apply to payments made from a trust. Thus, I.R.C. § 682 applies to alimony trusts as well as to trusts created independently of divorce.

125. I.R.C. §§ 652, 662 (CCH 1985) (trust income taxed to beneficiaries); I.R.C. § 671 (CCH) (grantor treated as owner in circumstances described in §§ 673-77).

126. I.R.C. § 676 (CCH 1985).

127. I.R.C. § 673 (CCH 1985).

128. I.R.C. § 674 (CCH 1985).

129. I.R.C. § 675 (CCH 1985).

130. I.R.C. § 677 (CCH 1985).

131. I.R.C. § 682(a) (CCH 1985).

indicates that the beneficiary, and not the settlor, is taxed, even if the trust lasts for less than ten years, if the settlor retains broad administrative powers, or if the income can be used to discharge the settlor's duty to support the beneficiary.<sup>132</sup>

The six-year rule and alimony recapture rules do not apply to alimony trusts. For example, if one spouse establishes a three-year trust that generates \$25,000 income per year, which is distributed to a former spouse, the former spouse would report all the income (and the settlor spouse would report none). It might even be possible to fund such trusts with borrowed money. The settlor would then deduct interest paid on money borrowed to fund the trust, and the income generated by the trust would be taxed to the beneficiary spouse.<sup>133</sup>

Whether alimony trusts can be used to shift the tax burden on income used to support minor children is not clear. Section 682 provides that it does not apply to "that part of any . . . income of the trust which the terms of the [separation instrument] fix, in terms of an amount of money or a portion of such income, as a sum which is payable for the support of minor children of [the] husband." This provision is almost identical to section 71(c)(1), relating to child support payments. The Supreme Court, in the *Lester* case, had interpreted former section 71 to mean that income would not be considered to be child support merely because payments are to be reduced or terminated upon the occurrence of a contingency relating to a child.<sup>134</sup> The 1984 Act amends section 71 (by adding section 71(c)(2)) to reverse the *Lester* decision as it applies to alimony payments, but the 1984 Act does

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132. Because the beneficiary is taxed only on amounts that he or she "is entitled to receive," a grantor might be taxed on the income of a revocable trust or a trust where the grantor retains the right to allocate income among beneficiaries. The beneficiary in such cases is not necessarily "entitled to receive" anything from the trust.

If the trust is a short-term trust in which the grantor retains the reversionary interest, the Commissioner might assert that the below-market interest rules apply. Technically, a grantor who creates a short-term trust with a retained reversion does not loan anything to the trust. Substantively, however, a three-year trust with a retained reversion is similar to a three-year term loan. There are real differences, of course, because a creditor of a term loan is entitled to get back precisely what was advanced, while a grantor of a short-term trust who retains a reversion is entitled to receive back whatever corpus the trust has, which could be a larger or smaller amount than the amount contributed. It seems unlikely that Congress intended to treat gifts as loans when it adopted the below-market interest rules, but it is at least possible that a grantor of a short-term trust would be charged with imputed interest income on the value of the property transferred to the trust.

133. The transaction would not be effective if it were held to be an interest-free loan from the settlor to the beneficiary of the trust. In that case, the settlor would have imputed interest income from the amount transferred to the trust. I.R.C. § 7872 (CCH 1985). In form, a transfer to a trust in which the settlor retains a reversion is not a loan. In substance, however, a settlor who retains a reversion in a short-term trust may be difficult to distinguish from a creditor.

134. *Commissioner v. Lester*, 366 U.S. 299 (1961).

not amend section 682. Taxpayers can therefore argue that the rule of the *Lester* case still applies to the income of alimony trusts.

As a general matter, persons should not be able to use alimony trusts to accomplish tax results that cannot be accomplished by direct alimony payments. Section 682 should not become a backdoor means of circumventing the six-year rule or of resurrecting the *Lester* rule. The appropriate remedy, however, is not to construe an amendment of section 71 as an implied amendment of section 682. A taxpayer who created an alimony trust providing undifferentiated support for spouse and children prior to adoption of the 1984 Act should be entitled to assume that the *Lester* rule continues to apply to the trust. The *Lester* rule should also apply to trusts created after 1984 because section 682 was not amended in 1984.

Sections 682 and 71 should be amended so that they are consistent with each other. Section 682 could be amended so as to repeal the *Lester* rule as it might apply to alimony trusts, and so as to incorporate the six-year rule and the alimony recapture rules. These steps would make section 682 consistent with section 71, but in my view they would also extend bad policy decisions to a new area. If section 71 is amended by restoring the *Lester* rule and by repealing the six-year rule and alimony recapture rules, further amendment of section 682 might not be necessary. The Commissioner should in any event rule on the general question of the extent to which the below-market interest rules of section 7872 could apply to short-term trusts in which the grantor retains a reversionary interest.

Unless section 682 is modified, however, the *Lester* rule should apply to alimony trusts. Absent legislative revision, it would seem appropriate for a spouse with a fifteen-year-old child to borrow money to fund a trust whose income is payable to the other spouse for three years. If the trust is created pursuant to divorce and the payments to the beneficiary spouse are not specifically designated as child support, the settlor of the trust should not be taxed. Such a result may be regrettable, but it is a result to be cured by Congress and not by the courts.

#### IV. DEPENDENCY EXEMPTIONS

If divorced or separated parents together provide over half the support of a child, one of the two parents is usually entitled to claim the child as a dependent for tax purposes.<sup>135</sup> When both parents provide some support,

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135. See I.R.C. § 152(e) (CCH 1985). If a third party (e.g., a grandparent) provides over half the support, the parents are not entitled to the dependency exemption. *Hopkins v. Commissioner*, 55 T.C. 538 (1970). Support provided by a new spouse of one of the parents is considered to be provided by the parent if a joint return is filed. See *Colton v. Commissioner*, 56 T.C. 471 (1971); Rev. Rul. 73-175, 1973-1 C.B. 59. If no person provides over half the support of the child, no exemption is allowed unless the parties file a multiple support agreement under I.R.C. § 152(c).

both are inclined to claim the child as a dependent.<sup>136</sup> In 1967 Congress attempted to resolve this problem by providing that, as a general rule, the parent having custody of the child for the longer period of time would be entitled to the exemption allowance.<sup>137</sup> There were two exceptions to this general rule. Under the first exception the noncustodial parent became entitled to the deduction if he or she contributed at least \$600 toward the support of the child and the divorce or separation instrument provided that the noncustodial parent was to receive the deduction. Under the second exception, a noncustodial parent providing at least \$1200 for the support of a child<sup>138</sup> was presumed to have provided the greater amount of support (and was therefore entitled to the deduction) unless the custodial parent could “clearly establish” that he or she provided more support than the noncustodial parent.<sup>139</sup>

The 1984 Act eliminates both these exceptions to the general rule that the custodial parent is entitled to dependency exemptions for children.<sup>140</sup> The first exception (allowing the deduction to a noncustodial parent if the divorce or separation instrument specifically awarded the deduction to that parent and if he or she contributed at least \$600 toward the support of the child) continues to apply, however, to divorce or separation instruments executed before 1985.<sup>141</sup> The second exception (creating a presumption that the noncustodial parent paying \$1200 toward the support of a child provided the greater portion) is repealed even as to divorce or separation instruments executed or issued before the effective date of the 1984 Act.

Under the 1984 Act the custodial parent is entitled to the dependency exemption available to the parents unless that parent signs a written declaration that he or she will not claim the child as a dependent.<sup>142</sup> The noncustodial parent must attach a copy of the declaration to his or her return.<sup>143</sup>

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136. “It has been estimated by the Service that during a recent year 5 percent of all income tax cases handled at the informal conference level of the administrative process involved this issue as the principal issue.” H.R. REP. NO. 102, 90th Cong., 1st Sess. (1967), *reprinted in* 1967-2 C.B. 590, 592.

137. Act of Aug. 31, 1967, Pub. L. No. 90-78, 81 Stat. 191 (1967), *reprinted in* 1967-2 C.B. 502, *amended by* I.R.C. § 152(e) (CCH 1985).

138. Tax Reform Act of 1976, Pub. L. No. 94-455, § 2139(a), 90 Stat. 1932, *amended* I.R.C. § 152(e) to provide that a presumption of support could be claimed by a noncustodial parent (in the absence of a decree allocating the exemption to him or her) only if he or she provided \$1200 or more for each dependent child.

139. See Act of Aug. 31, 1967, Pub. L. No. 90-78, 81 Stat. 191, *reprinted in* 1967-2 C.B. 502, *amended by* I.R.C. § 152(e) (CCH 1985).

140. I.R.C. § 152(e)(1) (CCH 1985).

141. I.R.C. § 152(e)(4) (CCH 1985).

142. I.R.C. § 152(e)(2) (CCH 1985). A multiple support agreement can still take precedence if one has been executed. I.R.C. § 152(e)(3) (CCH 1985).

143. I.R.C. § 152(e)(2)(B) (CCH 1985). “The written declaration may be made on a form to be provided by the Service for this purpose. Once the Service has released the form, any declaration made

It is not certain whether the dependency exemption issue can ever be resolved satisfactorily. The 1984 amendments are probably a substantial improvement over prior law, but problems will persist. In joint or shared custody arrangements, for example, both parents may claim to have custody for the greater portion of the year. While this problem could be alleviated by a statutory provision stating that the custodial parent is the parent so designated in the divorce or separation instrument, no such provision now exists. The issue could be resolved to some extent by agreement among the parents designating which parent shall be the custodial parent for tax purposes. Although such an agreement would not be binding for tax purposes, it would be effective as a practical matter if the person designated as the noncustodial spouse agrees to hold the designated custodial spouse harmless from tax liability based upon a finding that the person designated as the custodial spouse does not in fact have custody.

A question less easy to resolve is whether a custodial spouse who agrees to declare that he or she will not claim a child as a dependent should issue a written declaration for the entire period of a child's minority or should do so only on a year-to-year basis.<sup>144</sup> If a declaration is effective for a period of more than one year, the noncustodial parent will be able to claim the child as a dependent even in years in which the noncustodial parent pays absolutely no child support. On the other hand, if the custodial spouse is to issue written declarations on a year-to-year basis, the noncustodial parent may be unable to claim a child as a dependent in a year in which all child support is paid, merely because the custodial parent refuses to issue a written declaration. On balance, it would seem better for the parties to agree that if written declarations are to be issued they should be issued on a year-to-year basis, and on condition that all child support payments have been made. The agreement could provide further that the noncustodial parent has no obligation to pay child support for any period during which the custodial parent unreasonably fails to issue a declaration. The custodial parent might refuse to honor such an agreement, but it would usually not be in her or his interest to do so because the noncustodial parent could respond by discontinuing (or reducing) child support payments.

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other than on the official form shall conform to the substance of such form." Treas. Reg. § 1.152-4T(a)(Q & A 3) (1984).

144. An exemption may be released for a single year, for specified years (e.g., alternate years), or for all future years. Treas. Reg. § 1.152-4T(a)(Q & A 4) (1984).

## V. AN ASSESSMENT AND SOME PROPOSALS

The law governing the tax consequences of divorce has become extremely complex. It will be difficult for lawyers to apply that law intelligently and even more difficult for their clients to understand it or to feel that it is fair and just. These results are most unfortunate. Complexity in some areas may be justified because the underlying transactions themselves are complex and the transactions are likely to be supervised by experts. That is not so of divorce. Attorneys in general practice represent clients who divorce, and the clients themselves are not usually sophisticated in tax matters. While some financial transactions caused by divorce can be complex, the new provisions will trap the unwary taxpayer even in the simplest cases. For example, a taxpayer will not be able to deduct payments if he or she pays temporary support pursuant to a decree that does not state expressly that payments shall terminate upon the death of the payee. The taxpayer who fails to pay alimony for whatever reason for a given year may have to cope with the concept of alimony recapture, and it may be the duty of the lawyer to explain this new fact of life to a client seeking a divorce.

The provisions relating to alimony do not even accomplish commonly understood goals. On balance, the Domestic Relations Tax Reform Act of 1984 is a travesty imposed on the general public and on lawyers in general practice by specialists. In one sense, the real issue is not *whether* the Domestic Relations Tax Reform Act of 1984 is bad legislation, but how such a legislative monstrosity could have developed in the first place.

I believe the tax law relating to payments and transfers made pursuant to divorce should express three commonly accepted principles:

- (1) Transfers of property pursuant to divorce should not be taxable in the absence of an outright sale between the parties.
- (2) Payments made pursuant to divorce by one spouse for the property interest of the other spouse should not be deductible by the payor spouse.
- (3) Parties to a divorce should themselves be able to determine which spouse should be taxed on amounts earned by one spouse and paid to the other spouse for the support of the payee spouse or for the children of the parties.

These basic principles could have been effected simply by enacting section 1041 as it now exists, but without amending section 71. Such a simple step, however, would fail to correct what appears to have been a major administrative problem.

Because payments were “alimony” only if they were for “support” and not if they were for property or for an “inchoate right,” taxpayers sometimes—perhaps often—whipsawed the Commissioner in the following manner: the payee would fail to report periodic payments, claiming that

they were made for something other than support, but the payor would deduct them on the claim that they met the objective tests of section 71 and were for support. The Commissioner could assert deficiencies against both parties, but much revenue was undoubtedly lost. Section 71 was therefore amended, *presumably* to replace the subjective "support" test with more objective tests. Those objective tests, however, are entirely unsatisfactory. The objective tests proposed by a task force of the American Bar Association were not much better.

What is needed is a relatively simple change to solve what was essentially an administrative and compliance problem. The beginning point now is to repeal section 71(f), which contains the six-year rule and alimony recapture rule. Section 71(b)(1)(D) should then be modified to eliminate the requirement that the divorce or separation agreement specify that there is no obligation to make any payment for any period after the death of the payee.

These changes would simplify life for taxpayers and their advisors, but a further change would be required to prevent taxpayers from deducting the costs of purchasing the property of a spouse pursuant to divorce, and also to prevent taxpayers from reporting cash payments inconsistently at government expense. I believe these goals could be accomplished by the following methods:

- (1) Payments constituting alimony should, as an initial matter, be income to the payee if they constitute alimony under the objective tests of section 71(b), modified as described above.

- (2) Includibility in gross income by the payee, however, would not guarantee deductibility by the payor. Payments includible by the payee under section 71 would be deductible by the payor only to the extent that the payor can establish that the payments are made for the support of the payee and are not designed to compensate the payee for a property interest or inchoate right arising out of the marital relationship.

- (3) To prevent overzealous auditing by the Commissioner, an additional statute could provide that if amounts initially reported by the payee as income under section 71 are held to be nondeductible property settlement payments in a final determination involving the payor, the Commissioner should recompute the tax of the payee for the year of payment by excluding the payment from income.

These provisions would be far simpler than the present framework. They would eliminate situations in which one spouse neglects to report payments (on the claim that payments are not for support) even though the other spouse deducts them. These provisions would not eliminate situations in

which unaudited taxpayers deduct the cost of purchasing property interests, but the other spouse would at least report those payments as income. I doubt whether more payments would be deducted than are deducted under the present scheme. The proposal would contain a built-in measure of protection: the payee could inform the Commissioner that payments, though income to the payee, are not for support. A resulting deficiency against the payor would lead to a refund for the payee under the optional provision suggested above. Prior knowledge of these relatively simple principles should discourage blatant disregard of the rule that payments for property are not to be deducted.

If sections 71 and 215 are simplified in the manner suggested, the *Lester* rule should be reinstated by repealing section 71(c)(2). Section 71 now permits parties to determine which of the parties will be taxed on income earned by one spouse and paid to the other spouse for her or his support. Taxpayers who are competently advised will probably usually decide that the income should be taxed to the person in the lower bracket. I know of no compelling reason why this principle should not be extended to payments made to support minor children of the parties. There was no great clamor against the *Lester* rule. The rule permitted parties to determine which spouse should pay the tax on income used for child support. By specifically designating certain payments as child support, the parties could cause the payor to be taxed. By not designating payments as child support but by providing for reduction or termination of payments when a child attained majority, the parties could cause the payee to be taxed.

One criticism that might be levelled against the *Lester* case is that it encouraged parties to designate as "maintenance" something that was intended to be child support. The *Lester* case may have encouraged cant and hypocrisy and, more to the point, may have deprived some custodial parents of legal protections afforded to child support but not to alimony. If these criticisms are correct, the proper response would be to repeal section 71(c) altogether and place child support payments in the same category as alimony. If the requirements of section 71(b) are met, both should be deductible to the extent that the divorce or separation instrument designates them as payments that are excludible by the payee and nondeductible by the payor. If there is no reason to treat alimony more favorably than child support, it is equally true that there is no reason to treat child support less favorably than alimony.

All of these revisions could lead to a so-called "divorce bonus": Persons previously filing one return on joint income could file two returns on separate incomes, one as a single taxpayer and the other as a head-of-household. One can conjure up situations in which taxpayers with children could save substantial amounts of taxes under the revisions I propose. One



can already conjure up such situations, however, and I am not unduly concerned by the specter of a "divorce bonus." For every case of taxes reduced by reason of divorce there is probably at least one case of reduced ability to pay caused by the divorce. Divorce is not something that is welcomed by most persons affected by it. It is a time of trauma, adjustment, and, often, financial difficulty for the spouses and their children. The changes that I propose would lead to a simple tax structure for transactions related to divorce. The structure could be understood by lawyers in general practice and judges. Persons affected by divorce, and the general population as well, would find these proposals acceptable and fair.